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Financial Reform Legislation

On May 20, the Senate passed its 1615-page version of financial reform legislation, H.R. 4173, "Restoring American Financial Stability Act of 2010," which will put in place some of the most significant changes to the regulation of the financial services industry since the Great Depression. The House of Representatives adopted a similar bill (also H.R. 4173) in December 2009. It is expected that a modified version of the Senate Bill will be worked out in conference between the two houses of Congress in short order, enacted into law and signed by the President over the summer. Although as of the date of this writing, the details had not yet been worked out, the Senate and House bills are similar enough, and the dialog between the conferees and the Administration open enough, that the broad outlines of what is likely to be enacted are clear.

The legislation does what is politically popular with the voters back home, but not necessarily what is needed to finish resolving the recent "Great Recession" or to prepare for the next downturn. Not surprising, since the law is being developed and adopted by Congress before the commission that was formed to study the economic crisis has finished its work or published its findings. Much of the legislative effort has involved stoking up public sentiment against large financial institutions in order to create politically acceptable scapegoats for the financial crisis and channel public anger away from the legislators and certain of their favored constituents and industries (autos and housing) on which the federal government larded support and has lost vast sums of money in the bail-out. The reality is that Wall Street (securities firms and large banks) has repaid its loans and the government turned a huge profit. Main Street (auto companies, GSEs, and some local banks) has not. This "reform" legislation is an adroit political act, but not necessarily a well-considered economic one in all of its parts.

Also of note is that the House and Senate delegations from the Northeastern states that are dependent upon financial services companies for jobs and tax revenues appear not to have realized the damage the legislation may inflict upon their home districts until very late in the process.

The legislation includes the following key elements, which are being addressed in more detail in this issue as well as upcoming issues of *The Investment Lawyer*.

The centerpiece of the legislation is its program for oversight of "systemically significant" or "too big to fail" financial services firms. Title I creates a powerful new Financial Stability Oversight Council, comprised of representatives of the US Treasury Department

(Treasury), the Federal Reserve, Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), the Federal Trade Commission (FTC), the Federal Housing Finance Agency (FHFA) and the Commodity Futures Trading Commission (CFTC), among other agencies. The Council's task is to identify, with the help of professional staff in the new Office of Financial Research and the Federal Reserve, those large (over $50 billion in assets) and interconnected financial services firms that will be designated as systemically significant and subject them to additional capital requirements, leverage limits, liquidity requirements, pre-packaged wind-down plans, concentration limits, activities restrictions, risk management, and disclosures, as well as to on-going Federal Reserve oversight. This designation will likely have the greatest impact on large financial firms that currently are not banks or bank holding companies, which already are subject to much of this. Title II imposes a federal receivership process on systemically significant financial services firms that become insolvent or that are in danger of insolvency, if the Council determines that their failure would pose a risk to the economy. This process is modeled on FDIC receivership law, rather than normal bankruptcy provisions. The main differences include that: (1) the process is orchestrated by the federal government acting unilaterally and subject to after-the-fact judicial review on a limited basis, rather than by a committee of creditors working with the debtor, subject to bankruptcy court approval on an on-going basis; and (2) the prime directive is to prevent harm to the economy and cost to taxpayers, rather than to reduce the impact on creditors of the insolvent company. Title VIII imposes federal oversight on clearing mechanisms, settlement and payment systems and similar financial market utilities deemed to be systemically important.

The next most important part of the legislation is contained in Title X, which creates a new consumer regulator, the Bureau of Consumer Financial Protection, housed within the Federal Reserve System but partially independent of it. Various consumer banking and finance rules (although generally not covering securities or insurance firms) will be under the jurisdiction of this new regulator, which will have rulemaking and enforcement authority to broaden out these consumer protection mandates. A significant role of this consumer regulator may involve implementing parts of the legislation relating to borrower suitability requirements that are designed to curtail subprime and predatory lending that may have the effect of tightening consumer credit standards. An analogous provision is contained in the House Bill. This could be the most important part of the legislation in effecting real reform if its effect is to restrict loose consumer credit standards, which together with lax securitization standards by which easy credit was financed, was a key cause of both the economic bubble and the Great Recession that popped it.

Gaining less attention, but in the long run potentially the third most significant part of the legislation, is in Title V of the Senate Bill, which creates a beachhead for federal regulation of insurance companies (other than health and crop insurance), through the creation of a federal oversight agency for the industry with the power to recommend insurance companies for regulation as systemically significant, and to conduct a study for possible additional future federal regulation of the industry.

Title VI of the Senate Bill makes a number of other changes to the regulation of banks and their affiliates, including additional limits on counterparty exposure by a bank and its affiliates to other companies such as credit, derivatives and other risk exposure, enacts a statutory "source of strength" obligation for holding companies to support their depository institution subsidiaries, and imposes additional restrictions on transactions with certain types of affiliates of a financial institution. This Title also includes the "Volcker Rule" which, subject to modification by the Council, restricts most types of proprietary trading by banks and bank holding companies and their affiliates, as well as sponsorship of and investment in most types of private investment funds. The rule also imposes greater affiliate transaction restrictions between a bank and its affiliates on the one hand, and any private investment funds operated by the organization. There is no similar provision in the House legislation, but a version of this provision will likely be included in the final Act agreed to in conference.

Title VII of the Senate Bill addresses over-the-counter derivatives in two basic ways. One provision forces most over-the-counter derivatives into a central clearing mechanism and provides for more regulation and oversight of swap dealers, major swap participants, and swaps markets. Versions of this are in both the Senate and House legislation and will likely be in the Act. The Senate Bill also includes the "Lincoln Amendment," which would force most swaps trading out of FDIC-insured depository institutions and into uninsured affiliates. House Financial Services Chair Barney Frank has indicated that he opposes the Lincoln Amendment, as have (more quietly) the Treasury and the Federal Reserve, and thus there is a significant likelihood that it will be modified or removed in conference.

Other provisions of the Senate Bill do away with the Office of Thrift Supervision and move its functions in regulating savings associations to the OCC (federal savings associations), FDIC (state savings associations) and Federal Reserve (savings and loan holding companies).

The Senate Bill also imposes additional corporate governance requirements on public companies and executive compensation limits on bank holding companies, imposes additional restrictions on credit rating agencies and removes the direct link between credit ratings and certain securities law exemptions, imposes additional restrictions and requirements upon the asset securitization process, and new requirements for municipal securities issuers and dealers.

The Senate Bill also removes the "fewer than 15 clients" exemption from the Investment Advisers Act of 1940 (Advisers Act), creates a new exemption for "family offices," requires registration of advisers to hedge funds (but not private equity or venture capital funds), imposes recordkeeping and other regulatory requirements upon advisers to private investment funds, and increases the threshold for SEC (rather than state) registration of investment advisers to $100 million (up from the current $25 million). The Senate Bill imposes Public Company Accounting Oversight Board (PCAOB) audit requirements on broker-dealers, provides for a study and rulemaking on additional point of sale disclosures for broker-dealers and possible limitation on pre-dispute arbitration clauses, moves SEC examination Staffs back into their respective divisions within the SEC, and creates a program of Federal Reserve supervision of holding companies of securities firms with international operations (replacing the old "investment bank holding company" program). The Senate Bill also mandates rulemakings and inflation indexing of the definition of "accredited investors" in Regulation D. The House Bill requires registration of investment advisers to private investment funds, with an exclusion for venture capital (but not private equity) funds. The Senate Bill requires an SEC study of fiduciary standards and regulatory oversight of broker-dealers and investment advisers. The House Bill imposes fiduciary requirements from the Advisers Act upon broker-dealers that provide personalized investment advice to retail customers.

A significant concern with the legislation is that it further restricts the ability of the Federal Reserve, the FDIC, and the Treasury to deal with the next financial crisis. The Great Recession was a liquidity crisis and a crisis of investor and lender confidence. The job done by those three government bodies in preventing a complete meltdown of our economic system over the past two years has been stellar. Not only did the Federal Reserve and Treasury's careful actions prevent collapse, they managed to turn a very large profit for the government on both the Federal Reserve's emergency lending program (over $100 billion in profits according to recent Treasury and Congressional Budget Office reports) and the bank and securities firm portion of the Troubled Asset Relief Program (TARP) according to Treasury estimates. For its part, the FDIC has managed to resolve a very large number of troubled banks (most of which, contrary to public impression, have been smaller "main street" institutions, rather than money center or super-regional Wall Street firms) while restoring its own reserves and capital resources. Where government money was lost was in the bail-out of the auto companies, Fannie and Freddie, and AIG, not on the bail-out of bank or securities firms.

But the next time this happens, the Federal Reserve, FDIC and Treasury will not have the same leeway to take the bold steps that worked extraordinarily well this time.

Rather than build upon what worked—large scale liquidity injections into those institutions that could be saved and that could repay the government financing—the legislation seeks to build on what did not work—a further and very significant increase in ex-ante regulation of financial businesses with a view to preventing them from becoming insolvent in a future crisis. But the financial institutions that failed in this crisis were already heavily regulated and supervised by federal regulators to a degree that neither our elected officials nor the general public really understand. More of the same is unlikely to prevent a future economic crisis, particularly where the new regulatory regime does not deal with the main underlying causes of the problem.

The legislation does not mandate higher capital levels or less leverage for most financial firms, or for borrowers. Only the largest, most "systemically significant" financial institutions are likely to see increased capital requirements under the new legislation. And enhancing credit quality requirements on home loans is dealt with only in an oblique way through potential future rulemaking by the new consumer protection bureau.

The legislation does not deal with Fannie or Freddie, nor does it deal with unfunded pension liabilities in defined benefit plans of the sort that brought down the car companies and is on the verge of bankrupting a number of state and local governments.

Despite the massive length of the legislation, much of the detail of the new system of regulation remains to be developed by newly-created federal agencies and through studies and rulemakings by existing ones. Initial legislative plans to simplify and strengthen our regulatory system have given way to further complication of it. Whether the changes mandated by the legislation will benefit consumers or improve the economy remains to be seen. It may be many years before we learn whether the legislation achieves its goal of eliminating systemic risk in our financial system or instead merely masks systemic risk while undermining our national economic competitiveness.

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